Monthly Update

December 2019

By Peter Boockvar
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December capped an impressive year in markets, as the S&P 500 was higher by 29% and the ACWX ex US stock index was up 17%[1]. Bonds also had an amazing year with the Barclays Aggregate index up 8.8%[2]. In particular, the gains in stocks were certainly amplified by the market's starting point, after the sharp selloff in the fourth quarter of 2018. If we take a step back, the S&P 500 is higher by about 10% from the September 2018 level, before stocks sold off[3].

The rally in December was catalyzed by the same two things that have been boosting stocks all year; the Federal Reserve and the US/China trade situation. On the latter, we finally got a Phase-One deal, which is expected to be signed right after the New Year begins. We will still be left with almost all the tariffs, with no visibility as to when they will be removed, but we've taken off the table any escalation in tensions and that is what the market celebrated.

The Federal Reserve last cut rates in late October, but the world has been riding a wave of massive liquidity injections ever since. Since mid-September, the Fed has added hundreds of billions of dollars to the short-term repo market in order to quell a dislocation that occurred, which resulted in a spike in rates. The Fed has also resumed the expansion of their balance sheet in order to increase the amount of excess bank reserves that are placed with them, as another tool to aid the functioning of overnight lending markets. To quantify, they've added $400b to their balance sheet over the past four months, taking it to $4.2 Trillion, in addition to adding about $500b in short term repos[4]. The Fed did not want to call this another round of quantitative easing, following three prior rounds over the past 10 years, but the markets saw it as such.

I highlight the large influence that the Fed and a China trade deal had on markets in 2019, because if one just followed the actual economic and earnings fundamentals, one would be surprised by how robust markets were this year. The markets have essentially performed based on the hopes that a trade détente and Fed easing will lead to an inflection higher in business activity, and subsequently earnings, in 2020.

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1. – 4. Bloomberg

The Global Economy and Earnings

The US economy is likely to finish the year with about a 2% growth rate, as the US consumer offset the weakness in manufacturing, trade, and capital spending[5]. Growth in 2020 is expected to be about 2%, as currently estimated, with Q1 weighted down, in part, by Boeing's announcement to halt the production of the MAX aircraft[6]. The Eurozone economy is ending 2019 on a soft note, particularly driven by a slowdown in Germany manufacturing and the auto sector. However, the services sector has well outperformed. The net result is growth of about 1% in 2019, and the same pace is expected in 2020[7]. China, being the 2nd biggest economy in the world, is a key swing factor on how global growth plays out in 2020. It is possible that the growth rate will slip below 6% in 2020 for the first time a few decades[8].

The hope now, though, is that the US/China trade deal and the reduced tensions between the two countries will result in a quicker inflection higher in economic activity, notwithstanding tariffs being still around. We will be watching closely and are hopeful that is the case, especially in the manufacturing sector.

Earnings for Corporate America are expected to fall in Q4 when results are announced in January and February, and will be down for the full year 2019[9]. The main reason has been the margin pressure driven by higher labor costs, and for some, the tariffs. This is offsetting the increases seen in revenues. Higher labor costs are a double edged sword. It is very positive for employees, but crimps profit margins where companies try to offset it through other means, like raising prices, trimming hiring and hours, and cutting capital spending. As with the economy, the hope in 2020 is that revenue growth will accelerate, which should help to offset the cost pressures.

Valuations

The amazing rally in stocks, along with the slight year over year decline in earnings, has led to a sharp rise in the price-to-earnings ratio for the market. With regard to the S&P 500, we are now trading at about 20 times the 2019 estimate[10]. Thus, it is imperative that we get a lift in earnings growth in 2020 in order to grow into this rather rich multiple. Low interest rates certainly give the markets a license to have a higher earnings multiple, but slower earnings growth can be an offset.

5. – 10. Bloomberg

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The great year that corporate bonds, both investment grade and high yield, have had also left valuations extended in this asset class, as yield spreads relative to US Treasuries are similar to those seen in 2007[11]. The search for any kind of yield has been the main motivation. This doesn't imply that trouble is ahead, but rather, more limited opportunities for returns are likely upon us in fixed income.

When looking at valuations of fixed income, nothing is more out of whack than a bond that yields less than zero, as seen in Europe and Japan, where the borrower gets paid for borrowing. After peaking at over $17 Trillion, the dollar amount of negative yielding securities has shrunk to about $11.7 Trillion, as the rise in yields over the past few months has reduced this pile[12]. Where this dollar amount goes this year overseas might very well determine the direction of US longer term rates.

Interest Rates

This leads to my discussion on global interest rates, where the actions of central banks in 2020, just as they did in 2019, will also be a key main determinant of where they go from here. In December, the Swedish Riksbank decided to end their experiment with negative interest rates, as they raised interest rates by 25 basis points to zero[13]. The pressure is now on the European Central Bank to take its first steps to doing the same in 2020. We'll see if they follow, but if they do, I expect interest rates around the world to trend higher.

Conclusion

It's been an incredible year in just about every single asset class, but as stated, it is in the context of what we experienced in the fourth quarter of 2019. Either way, we take 2020 as a new year with new opportunities and challenges. The opportunities always arise. The challenges will be mainly valuations, where, as stated, we need to grow into the current multiple. It is for this reason that we need to be realistic about returns in the coming twelve months, as we are starting at a high valuation base. We also have to see the 2019 hope of an improving economy, via Fed rate cuts and a trade deal, be realized.

11. – 12. Bloomberg
13. Riksbank

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Regardless of what comes in 2020, we try to construct portfolios for our clients that are well-diversified, and with a long term time horizon in mind; an investor's two best friends. Of particular importance is making sure our clients have their liquidity needs met over the coming 24-36 month period, which then makes market gyrations less relevant during this time frame.

Please do not hesitate to reach out at any time with questions, or for any discussion on the economy or markets. We also want to wish you and your family an amazing new year!

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